

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 02-0241
Gross Retail & Use Tax-Production Exemption
For Years 1998, 1999, 2000

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ISSUES

I. Gross Retail and Use Taxes—Production exemption

Authority: IC § 6-8.1-5-1(b); IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-4; IC § 6-2.5-3-6; IC § 6-2.5-3-7; IC § 6-2.5-4-2(c); IC §§ 6-2.5-5-5-3, -5-1; IC § 6-2.5-5-5.1; IC § 6-2.5-5-9; 45 IAC 15-5-3(8); 45 IAC 2.2-2-1; 45 IAC 2.2-3-4; 45 IAC 2.2-5-8; *Harlan Sprague Dawley, Inc. v. Indiana Department of State Revenue*, 605 N.E.2d 1110 (Ind. Tax 1992)

Taxpayer protests the assessment of use tax on various materials, equipment, and utilities used in finishing customers' tangible personal property where no gross retail tax was paid at the point of purchase. Taxpayer claims the materials are exempt from tax because they are part of the production process.

STATEMENT OF FACTS

Taxpayer's business started out as furniture manufacturing; now, however, taxpayer "finishes" products manufactured by customers who send tangible personal property to taxpayer for the addition of paint, finishes, coatings, etc. Taxpayer then returns the items to its customers following packaging and labeling instructions required by each customer. Taxpayer also manufactures some tangible personal property based on specifications supplied by customers. The audit determined exempt percentages for items taxpayer produced, but did not exempt from tax items used solely in finishing customers' tangible personal property. Additional facts will be added as necessary.

I. Gross Retail and Use Tax—Production exemption

DISCUSSION

Taxpayer protests the assessment of use tax on various items taxpayer uses to apply paint, varnishes, coatings, etc. to tangible personal property manufactured by customers who send it to taxpayer for finishing. Taxpayer then returns the tangible personal property to the customers who have provided specific packaging and labeling instructions taxpayer must follow in returning the finished products to its customers. The audit determined that taxpayer was entitled to exempt finishing materials used on tangible personal property manufactured according to customer supplied specifications, approximately 25% to 30% of taxpayer's business.

The audit also determined that the required packaging and labeling for taxpayer's outside customers was non-exempt, finding that the labels were used for in-house inventory tracking. The audit also determined the packaging was non-exempt. The audit characterized 70% to 75% of taxpayer's business as being an industrial processor who returns customers' tangible personal property to them after processing.

Taxpayer argues that it is entitled to the full production exemption, claiming that the finishing of customers' tangible personal property by using the air hoist to position tangible personal property on the conveyor belt to transport it to the various rooms where paint, etc., is applied, constitutes direct use in the direct production of a customer's product. The audit had determined the air hoist was used to transport work-in-progress 50% of the time. Therefore, 50% of it was exempt and 50% of it was taxable. Taxpayer also argues that the packaging and shipping materials, including labels, are required components of the products shipped to their customers and are therefore an essential and required part of the production process. Taxpayer also argues that all of its utility usage is exempt, not just the percentages the audit had determined based on data taxpayer provided and on an agreed-upon methodology for determining usage.

Pursuant to IC § 6-8.1-5-1(b) and 45 IAC 15-5-3(8), a "notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the assessment is made." Pursuant to IC § 6-2.5-2-1, a "person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state." *See also*, 45 IAC 2.2-2-1. Pursuant to IC §§ 6-2.5-3-1 through 6-2.5-3-7, an "excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana is the property was acquired in a retail transaction." An exemption is provided in IC § 6-2.5-3-4 if "the property was acquired in a retail transaction and the state gross retail tax" was paid at the time of purchase. Taxpayers are personally liable for the tax. (IC § 6-2.5-3-6). IC § 6-2.5-3-7 provides that a "person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana;" therefore, the presumption of taxability exists until rebutted. *See also*, 45 IAC 2.2-3-4.

The specific statute at issue, IC § 6-2.5-5-1, provides in pertinent part:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

The specific regulation at issue, 45 IAC 2.2-5-8, provides in pertinent part:

- (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
- (b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.
- (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
- (d) Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

The general rule, outlined in great detail in the regulation, is that purchases are either subject to the state's gross retail tax or the state's use tax unless the specific exemption applies. The parameters of the so-called "production exemption" are narrow: to be exempt, the tangible personal property must be directly used in the direct production of other tangible personal property. The regulation defines direct use and direct production as requiring "an immediate

effect on the article being produced;” i.e., the production-exempt tangible personal property must be an essential and integral part of an integrated process.”

With respect to the air hoist system, taxpayer argued that using it to place truck wheels on the overhead paint conveyor was the first step in production. In reality, the air hoist system is used in pre-production; the system makes no changes to the wheels before they are placed on the paint conveyor. Plus, the air hoist system is equipment, not a consumable supply. Therefore, that part of the audit denying the production exemption for the air hoist system when it is being used for pre-production is correct.

Audit relied on the definition of an industrial processor set forth in IC § 6-2.5-4-2(c) to conclude that taxpayer was not in the business of manufacturing. With respect to this part of the statute, the tax court has stated “[n]othing in the context of this statute demonstrates its exemption provisions are to have a different meaning than those in the industrial exemptions, and the court therefore gives the utility exemption provisions the same meaning as their counterparts in the industrial exemptions.” *Harlan Sprague Dawley v. Indiana Department of State Revenue*, 605 N.E.2d 1222, 1230 (Ind. Tax 1992), citation omitted. “Processing” is one of the activities that generally entitles a taxpayer to other exemptions. IC §§ 6-2.5-5-3,-5-1. In this case, the utilities used in the operations related to taxpayer’s paint and other applications are the type of processing which would entitle taxpayer to the other statutory industrial exemptions. Accordingly, it would be entitled to the exemption for its utilities in light of *Harlan Sprague Dawley*.

With respect to taxpayer’s electrical usage, there are no exemptions for maintaining a controlled environment outside the production process. Taxpayer’s major argument here concerned the auditor’s methodology in assessing tax on electrical consumption. When given the opportunity to supply a different one, taxpayer did not provide one. Taxpayer supplied all data in connection with electrical usage. The paint shakers at issue were listed by taxpayer as being in the maintenance department. Therefore, that part of the audit denying the production exemption for electrical usage for heat and air conditioning outside the production process and for the paint shakers is correct.

However, with respect to all electric meters examined in the audit, the auditor prorated dollar totals and ended up with percentages of exempt and non-exempt usages. Based on *Harlan Sprague*, taxpayer should be allowed all applicable exemptions on all meters, both gas and electric. Audit should revisit this issue.

With respect to the air make-up system, taxpayer argued that the gas usage, recorded by three gas meters, should be 100% exempt because the system is used to comply with environmental quality standards. However, the gas used is not for preventing the expulsion of contaminants into outside air or water. Taxpayer cites Occupational Safety and Health Act requirements which benefit employees, not the environment. The Department’s consistent policy has been to use the Environmental Protection Act’s strictures and exempt equipment, etc., that help control outside environmental quality. Therefore, that part of the audit denying the production exemption for the air make-up system is correct.

Taxpayer claimed that the labels affixed to the packaging used to return customers' tangible personal property to them were not used for inventory tracking purposes, but because customers had definite requirements for the packaging and labeling of the packaging once their tangible personal property was ready to be returned to them. Customers' packaging and labeling requirements are not exempt from taxation merely because taxpayer must follow them in order to return customers' property to them. Taxpayer may be liable for damage, but taxpayer has no ownership interest in the property, nor is the property packaged for resale. Therefore, packaging and labeling materials are not exempt from the state's gross retail and use taxes. *See*, IC § 6-2.5-5-9.

FINDING

Taxpayer's protest concerning the assessment of use tax on items taxpayer alleged fell within the production exemption to the state's gross retail and use taxes is denied. That part of taxpayer's protest regarding gas and electric exemptions is sustained subject to review by audit.

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